ON THE ROAD TO BE AN INTERNATIONAL ISLAMIC CAPITAL MARKET CENTER

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ABSTRACT

This paper addresses the development of the Islamic debt securities in Malaysia with a focus on four key strategic initiatives that have been identified by Capital Market Master Plan to achieve the objective to establish Malaysia as an international Islamic capital market center. These initiative are, first, facilitate the development of a wide range of competitive products and services related to the Islamic capital market; second, create a viable market for the effective mobilization of funds; third, ensure that there is an appropriate and comprehensive accounting, tax and regulatory framework for the Islamic capital market and fourth, enhance the value recognition of the Malaysian Islamic capital market internationally.

1. INTRODUCTION

Malaysia in its Capital Market Masterplan 2001 addressed the growth and development in Islamic debt and aims to turn Malaysia into an international Islamic capital market center. The aim reflects an overarching aspiration that is intended to drive the development and strategic positioning of the Islamic capital market, and lays a strong foundation for further growth thereafter. In order to achieve the objective, four strategic initiatives have been identified. These strategic initiative are: first, facilitate the development of a wide range of competitive products and services related to the Islamic capital market; second, create a viable market for the effective mobilization of funds; third, ensure that there is an appropriate and comprehensive accounting, tax and regulatory framework for the Islamic capital market and four enhance the value recognition of the Malaysian Islamic capital market internationally. This paper addresses these strategic initiatives that form the basis for the Masterplan to achieve the objective.

There are a lot of potential for Islamic debt instruments in the domestic and international market. In the domestic market, Malaysia has huge domestic investible funds particularly from institutional investors such as Employees Provident Fund, Lembaga Tabung Haji and Lembaga Tabung Angkatan Tentera. Other investors include banking institutions, insurance companies, asset management companies and money brokers. All of them are always looking for the investment opportunities. Presently, suitable instruments have not emerged fast enough to absorb this investible fund. In the international market, funds from the middle east are coming out of the US and Britain after September 1997 and bombing in London July 2005 respectively. They are also looking for the new investment opportunities. Islamic investment is expected to expand at a rate of between 12% and 15% per annum over the next coming years. The largely untapped demand for Islamic financial products, both domestic and international, presents valuable opportunities for Malaysia to establish itself as a hub for the Islamic capital market.

2. THE RECOGNITION OF THE MALAYSIAN CAPITAL MARKET IN THE WORLD

Malaysia has achieved commendable progress in developing its Islamic capital market. Although we achieved commendable progress, we have yet to attain the desired recognition on an international level. As reported in the Capital Market Masterplan, an estimated US$800 billion of Islamic capital is presently invested in banks throughout the world.

However, there is a sign that Malaysia's Islamic debt securities are started gaining the recognition at the international market as stated in many comments in the literatures. As evidence, Malaysia has successfully

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launched Islamic bond in June 2003. The Bond USD600mln 5-year global Islamic bond was received international recognition and was well received by investors.

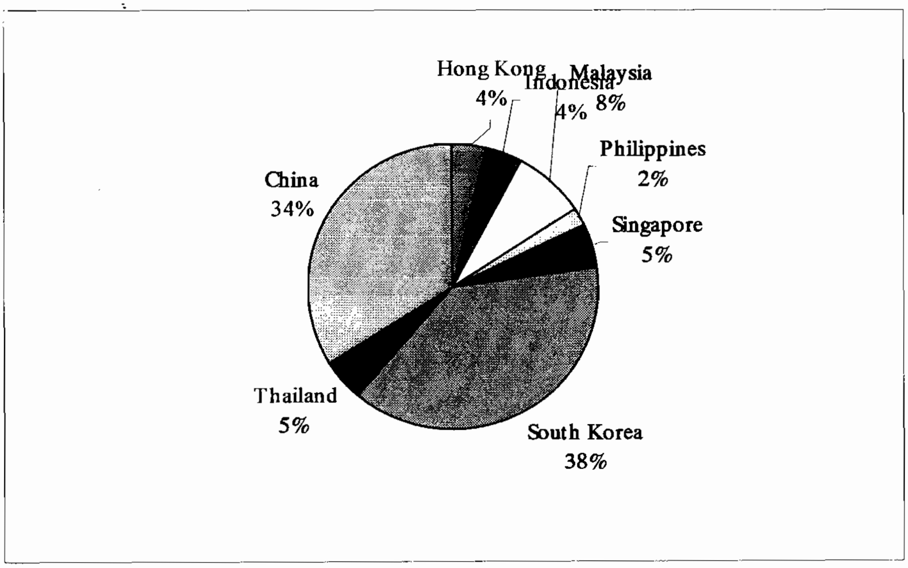
Malaysia also emerges as one of the most developed market in debt. Despite a small domestic market, Malaysia has the biggest size of bond market relative to Gross Domestic product (GDP) among Asian nations. Total outstanding ringgit bonds grew by 10.7% to RM363 billion in 2004, accounted to 81% of GDP, follow by South Korea 72% and Singapore 56%. Based on market capitalization, Malaysia accounts for 8% of total size of Asian bond market, ranked third after South Korea and China. This bond market share is the highest among South East Asian countries. Thailand and Singapore accounts 5% of total size of Asian bond market respectively.

Table 1
Size of Asian GDP and Bond Market

Country	Domestic market size (USD bn)	Percentage	Size of bond market/GDP
South Korea	488	38.8%	72.0%
China	442	35.1%	28.0%
Malaysia	96	7.6%	81.0%
Singapore	58	4.6%	56.0%
Thailand	57	4.5%	35.0%
Indonesia	47	3.7%	18.0%
Hong Kong	45	3.6%	27.0%
Philippines	25	2%	29.0%
Total	1258	100.0%	

Source: BIS, data as at 31.12.2004

Figure 1
Size of Asian Bond Market: USD1.43 Trillion



Source: BIS data as at 31.12.2004

3. PROGRESS OF ISLAMIC DEBT SECURITIES

The emergence of the modern Islamic financial market in Malaysia has been a relatively recent development as compare with the more established conventional financial system. It was only in 1983 that the first Islamic bank, Bank Islam Malaysia, was established to provide financial services according to Islamic principles. Shell MDS Sdn Bhd has issued the first private sector Islamic bond in 1990. Since then, many of the country's largest corporations such as Petronas, Tenaga Nasional and Telekom Malaysia have sought financing and issued long-term corporate debt using Islamic-based instruments. Despite its relatively nascent nature, the domestic market for Islamic securities has grown slowly but steadily over the last few years.

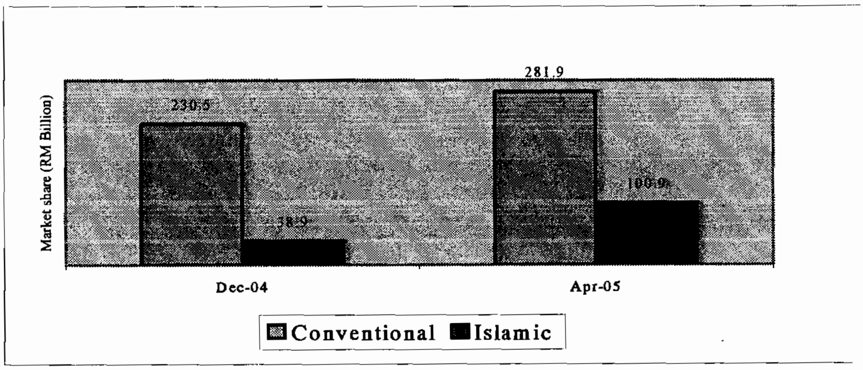
The rise of Malaysia's Islamic securities market took off after efforts by the government to spur Islamic instruments began post Asian crisis; follow by the introduction of Capital Market Masterplan. Demand for Islamic debt instruments, which accounted for only 7% of total bonds raised in 1999 grew to 25% in 2000 and subsequently to 36% in 2001. Significant growth of issuance over the years due to high demand for Islamic securities, relatively more cost effective for corporate issuers and increasing depth and breadth of Islamic money market.
Total Islamic financial instruments constitutes 26% (RM100.9 billion) of the total financial instruments issued (RM382.8 billion) in April 2005 as compare to only 0.14% (RM38.9 billion) of the total financial issued (RM269.4 billion) in December 2004. This indicates that Islamic debt securities are growing more significant as well as competitive as conventional instruments.

Table 1
Funds Raised in the Capital Market

	1996	1997	1998	1999	2000	2001
Value (RM million)						
Islamic bonds	2,350	5,249	345	1,734	7,666	13,028
Conventional bonds	10,034	10,222	10,487	20,399	14,884	17,289
Total PDS raised	**12,384**	**15,471**	**10,832**	**22,133**	**22,550**	**30,317**
Proportion (%)						
Islamic bonds	19	34	3	8	34	43
Conventional bonds	81	66	97	92	66	57

Bank Negara: Various years

Figure 2
Market Share of Islamic Instruments vis-avis Conventional



Source: RAM Bond NewsletterJanuary 2005

4. DEVELOPMENT IN ISLAMIC PRODUCTS AND SERVICES

The tremendous increased in demand for Islamic instruments primarily due to investor awareness of alternative funding sources and the increased number of Islamic funds launched over the years. No fewer than 40% of all Malaysian domestic bonds are now shariah's-compliant, especially the larger issues, and this proportion continues to grow. Shariah's compliant bonds are the instruments of choice for issuers, because they guarantee access to a larger investor base. The result is that Malaysia's Islamic financing landscape has advanced in term of products and services offered, further adding to the sophistication of the domestic capital market. This diversity of instruments and its modernity, as well as boasts a dual banking model whereby a developing Islamic financial system exists in parallel to the conventional banking system.

Presently, various products are available for those who seek to transact only in Islamic securities, including list of syariah-approved securities, Islamic debt securities, Islamic unit trusts, warrants based on Syariah-approved securities, and CPO futures. There are two Islamic equity indices, the KLSE Syariah Index and the RHB Islamic Index. In terms of services, the capital market offers Islamic product structuring, project financing, stockbroking and management services. Malaysia has a number of market intermediaries that cater specifically to Islamic capital market investors. There are a number of stockbrokers whom operate based on Syariah principles and on the asset management side, there are also few specialist Islamic asset management companies.

In the Islamic debt securities, the Al-Bai Bithamin Ajil (ABBA) structure has been the preferred choice to finance projects with high capital and long gestation periods. Besides ABBA, another popular Islamic securities tool is the Murabahah concept, which caters for short to medium-term requirements. Other Islamic concepts available to the market include Istisna, Ijarah, Mudharabah and Musyarakah.

5. LEGAL AND INSTITUTIONAL FRAMEWORK

As a sign of increased development within the Islamic financial industry, Bank Negara Malaysia has established several initiatives to encourage the growth of Islamic finance. The initiatives are as follows:

- Established agencies: In 1993, the first Islamic unit trust fund was launched, and in 1994 the first full fledged Islamic stockbroking company, BIMB Securities Sdn Bhd was established. In 1995, Capital Market Unit was established, comprising experts in *figh muamalat* and capital market practices, to undertake research in product origination and Islamic capital market operations.
- Enhance Shariah's standards: This falls under the purview of the National Shariah's Advisory Council which was established in 1996 to streamline and harmonise varying Shariah's interpretations amongst financial institutions.
- Resilient financial markets: The international Islamic Financial Market (IIFM) was jointly established in November 2001 by Malaysia and Bahrain with the purpose of facilitating the development of an international Islamic money market. This initiative is also being carried out by LOFSA (Labuan Offshore Financial Services Authority) to promote Labuan as international financial center.
- Uniform regulatory standards: The Islamic Financial Services Board (IFSB) works jointly with the IMF and the Islamic Development Bank (IDB) to standardized regulations and best practices within the Islamic financial industry.

Presently, Islamic financial and capital market products are burdened by additional taxes and duties due to additional transactions and instruments being required to comply with Syariah principles. As part of its initiative to assist in the development of Islamic debt, the Bank Negara also announced a few measures in the recent budget 2005. Additional tax or duty be exempted or given specific treatment for the Islamic financial products that approved by the Syariah Advisory Council Bank Negara Malaysia; and for the Islamic capital market products that approved by the Syariah Advisory Council, Securities Commission. The initiative is in line with the government's efforts to promote Islamic financial and capital market products and to ensure tax neutrality with conventional products.

6. MAJOR OBSTACLES TO THE MOBILISATION OF ISLAMIC FUNDS

No doubt, the increasing value of Islamic bonds has contributed to the development of the private debt securities market. However, private debt securities trading remain relatively inactive. Islamic bonds are issued through private placement (especially if the amount involve is large), allotting the bonds to government institution. As a result a large portion of the Islamic bond was allotted to government related institutions such as Employees Provident Fund (EPF), Lembaga Tabung Angkatan Tentera and Tabung Haji, which normally hold their bonds until maturity.

As most of the Islamic bonds are issued by private placement, issuers and investors are basically government-related companies. Hence, these institutions are seen been influenced by the government. As a result, investors are expected to accept the offered price of bonds. Therefore, bonds yields have been systematically distorted by the government. This implies that the market yield of most Islamic bonds is below that of the market. The secondary market is adversely affected by the distorted yields. Many banks have not actively traded in the secondary market partly to avoid losses. As Islamic bonds are issued in a manner similar to government bonds, trading remains inactive.

In addition, direct placements are likely to be less transparent, do much less in terms of promoting investor understanding of security, and may diminish the ability of investors to trade the bonds.

Lack of a benchmark yield curve hinders Islamic debt issuers from quoting an accurate price to potential sellers and would not help issuers and investors in their financing and investment decisions. Slow and inconsistent secondary market trading in Islamic debt securities as well as in Malaysian Government Securities, has held back the development of a benchmark bond.

7. CONCLUSION

It is apparent that Malaysia's Islamic capital market is on the track to achieve as an international Islamic capital market center. The basic market strength is more or less in place. With strong local and international untapped demand, product demand, mature banking structure, continued economic growth and the guidance of Bank Negara, Malaysia will remains fertile ground for the development of Islamic Capital market. However, still it has much to do to develop to the next phase. Islamic capital market is still new; there are many precautions and processes that need to be taken to further improve the viable market. Among others, improve the institutional framework within which Islamic products and services are delivered, established the reliable and efficient benchmark yield curve to ensure correct pricing are quoted, widening the issuer and investor base, minimize the sell of securities through private placement to avoid the yield distortion and improve liquidity in the secondary market.

The right mixes of strong cooperation between regulators, conductive market condition, shift of preference from conventional to Islamic principal and growing awareness to disintermediate away from traditional bank loans to alternative forms of fund raising are believed to be the key drivers to the meteoric growth in the Islamic capital market.

It is envisaged that the ringgit islamic bond market would continue to be the preferred avenue for raising funds amongst corporate entities as well as a preferred instruments for investments amongst institutional investors, financial institutions, insurance companies, asset management companies, money brokers and foreign institutions. Ringgit Islamic bond would grow at an incremental rate.

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